

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number: **199905026**

Refer Reply To:

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Date: November 2, 1998

LEGEND:

Company =

State X =

This is in response to a letter dated May 27, 1998, requesting a ruling concerning the exclusion of income of the Company from gross income under § 115 of the Internal Revenue Code.

FACTS

The Company provides a pooling network for participating risk-sharing pools of political subdivisions of various states. Many states, counties, municipalities and other political subdivisions have used risk-sharing pools for self-insurance. These risk-sharing pools often cover only a portion of each member's losses; the Company offers reinsurance coverage for the excess losses as an alternative to commercial reinsurance.

The Company is a nonprofit organization organized and licensed under the laws of State X. The Company is organized as a mutual industrial insured captive insurance company to provide various types of insurance and reinsurance coverage solely to its members. The Company uses an accrual method of accounting and is a calendar-year taxpayer.

Under the Bylaws of the Company, membership is limited to non-profit risk-sharing pools of political subdivisions of states, all of the income of which is excludable under § 115, and that are authorized by a state association or a risk-sharing pool affiliated with a state association to participate in the Company ("Member Pool"). A risk-sharing pool that seeks membership in the Company must file an application for membership and be approved by an

affirmative vote of the Company's Board of Directors. Membership in the Company is not transferable and will terminate if the Member Pool ceases to be reinsured by the Company or if the Member Pool is dissolved.

The business of the Company is governed by a Board of Directors elected by the Member Pools (at least one Director must be a resident of State X). The Company outsources most of its operational, management, and administrative services. In addition, the Company uses a servicing company to administer its claims and loss control services.

The Company provides automobile liability, general and product liability, workers' compensation, property liability, law enforcement liability, and public officials/errors and omissions coverage for its members. The Company's operations are limited to insuring or reinsuring losses of its Member Pools. The Company's income is used to pay reinsurance claims, expenses associated with such claims, and expenses of administration of the Company.

The Company's surplus is provided by Member Pools. Upon becoming a member of the Company, each Member Pool contributes an amount equal to a percentage of the actuarially determined net reinsurance premium that will be charged to the Member Pool under the agreement between the Member Pool and the Company for the ensuing policy year. The Company maintains a record of the contributions of each member. No part of the Company's net earnings inures to the benefit of any private person, and upon dissolution or liquidation, the Company's remaining assets must be distributed to either Member Pools or political subdivisions of states.

#### LAW AND ANALYSIS

Section 115(1) provides that gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a state or political subdivision of a state.

When determining if § 115(1) applies, the Service considers all the facts and circumstances relating to the organization to determine whether the organization performs an essential governmental function and whether the income of the organization accrues to a state or a political subdivision of the state.

Rev. Rul. 90-74, 1990-2 C.B. 34, concerns an organization formed, operated, and funded by political subdivisions to pool their casualty risks and other risks arising from their obligations concerning public liability, workers' compensation, or employees'

health obligations. The ruling states that the income of such an organization is excluded from gross income under § 115(1) so long as private interests do not participate in the organization or benefit more than incidentally from the organization. The benefit to the employees of the insurance coverage obtained by the member political subdivisions was deemed incidental to the public benefit.

Rev. Rul. 77-261, 1977-2 C.B. 45, holds that income from a fund, established under a written declaration of trust by a state, for the temporary investment of positive cash balances of a state and its political subdivisions, is excludable from gross income under § 115(1) of the Code. The ruling reasons that the investment of positive cash balances by a state or political subdivision in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and raise revenue.

The Company provides automobile liability, general and product liability, workers' compensation, property liability, law enforcement liability, and public officials/error and omissions coverage for its members. The Company's operations are limited to insuring or reinsuring losses of its Member Pools. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, the Company performs an essential governmental function within the meaning of § 115(1) of the Code.

Under § 115(1) of the Code, income of the Company must accrue to states or their political subdivisions. No part of the Company's net earnings inures to the benefit of any private person. In addition, upon distribution or liquidation, the Company's remaining assets must be distributed to either Member Pools or political subdivisions of states. Thus, the income of the Company accrues to political subdivisions of states and entities whose income is excludable from gross income under § 115.

#### HOLDING

Based on the information and representations submitted by the company, we hold that the income of the Company is excludable from gross income under § 115(1).

Except as specifically ruled upon above, no opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provision of the Internal Revenue Code. Specifically, we express no opinion whether the Company qualifies as an insurance company under any provision of the Code, including subchapter L of Chapter 1.

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This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel  
(Financial Institutions and Products)

By: Alice M. Bennett  
Alice M. Bennett  
Chief, Branch 3

enclosures: Copy of letter for section 6110 purposes